

STATE OF WASHINGTON
STATE INVESTMENT BOARD

Private Markets Committee Meeting
Minutes

September 9, 2004

The Private Markets Committee met in open public session at 9:06 A.M. in the boardroom at the Washington State Investment Board in Olympia, Washington.

Members Present: Patrick McElligott, Acting Chair
John Magnuson
Mike Murphy
Jeff Seely

Members Absent: Debbie Brookman
John Charles
Jeff Hanna
Senator Zarelli

Other Board Members
Present: George Masten

Others Present: Joe Dear, Executive Director
Gary Bruebaker, Chief Investment Officer
Tom Ruggels, Senior Investment Officer – Private Equity
Isabelle Fowler, Investment Officer – Private Equity
Gary Holt, Investment Officer – Private Equity
Steve Draper, Senior Investment Officer – Real Estate
Hanna Jirasetpatana, Investment Officer – Real Estate
Linda Buchanan, Administrative Secretary

Paul Silver, Senior Assistant Attorney General
Eric Becker, Pacific Corporate Group
Wesley Edens, Fortress
David Cody, Fortress
Katie Cattnach, INVESCO Private Capital
Mary Kelley, INVESCO Private Capital
Karen Jakobi, Pathway Capital Management
Terry Melican, Pathway Capital Management
Eileen Byrne, Townsend Group
Linda Assante, Townsend Group
Michael Humphrey, Courtland Partners
Dan Schulte, Principal Enterprise Capital
Steve Schoon, Principal Enterprise Capital
Ellis Short, Lone Star

[Names of other individuals attending the meeting are not included in the minutes but are listed in the permanent record.]

The meeting convened at 9:06 A.M. with Acting Chair McElligott identifying members present.

Acting Chair McElligott announced that Agenda Item 2, Private Equity – Annual Commitment Plan Update, would be discussed after Agenda Item 7, Private Equity – Secondary Investment Opportunity.

REVIEW AND APPROVAL OF MINUTES – JUNE 3, 2004

The adoption of the minutes was postponed due to a lack of quorum.

PRIVATE EQUITY – FORTRESS INVESTMENT FUND III, L.P. – INVESTMENT RECOMMENDATION

Mr. Holt introduced himself and Mr. Becker, Pacific Corporate Group (PCG). Mr. Holt stated that staff recommends an investment of up to \$200 million in Fortress Investment Fund (FIF) III, consistent with the annual commitment plan. He explained that the Board has an existing relationship with Fortress, having committed \$100 million to FIF II, \$200 million to FIF I, and \$100 million to BlackRock Asset Investors, which was a predecessor to the Fortress funds managed by the same team. Mr. Holt explained that staff believes this is an opportunity to expand an existing relationship with a very strong partner. He stated that the greatest strength of Fortress is its founder, Mr. Wesley Edens, although he is supported by a strong team. Fortress has offices in New York, London, Rome, and Frankfurt. Mr. Holt discussed Fortress's track record, strategy, and quick return of capital. He described FIF III's fit in the WSIB portfolio, providing diversification within the corporate finance section without overlapping the strategies of other partners. Mr. Holt stated that the key man provision helps to mitigate any risk posed by the potential loss of Mr. Edens.

Mr. Becker, PCG, introduced himself and stated that he recommends Fortress for the second time. He explained that Fortress is performing well. Mr. Becker discussed the firm's governance, organization, performance record, top-quartile returns, risk management, low loss ratio, strategy, comprehensive analysis, and innovative financial techniques. He described the partners' experience and credibility. Mr. Becker stated that the company has grown rapidly. He explained that any potential risk posed by the growth is mitigated by the fact that over 100 employees have been added to the firm; the hedge funds are managed by separate, dedicated teams; and the key man provision. He stated that synergies and benefits accrue because of the added business lines.

Discussion ensued regarding the Green Tree investments, bailout of Consecro, and the Consecro relationship with Hometown America.

Mr. Edens, Fortress, introduced himself and Mr. Cody. Mr. Edens explained the firm's performance history, investment record, principals, strategy, investment approach and exposure, rapid return of capital, substantial cash flows, and geographic diversification. He discussed investment opportunities and market conditions. Mr. Edens described the fund's size and terms.

Discussion ensued regarding pricing methods versus returns, competition with other WSIB partners, impact of having both real estate and hedge funds within Fortress, proposed legislation affecting company structure in the U.K., potential competition with U.S. real estate investment trusts (REITs), transaction fees, and alignment of interest.

Mr. McElligott stated that it was the consensus of the members present to forward this item to the Board for consideration of an investment of up to \$200 million, plus fees and expenses, in Fortress Investment Fund III, L.P., subject to continued due diligence and final negotiation of terms and conditions.

[The Committee recessed at 9:51 A.M. and reconvened at 10:06 A.M.]

PRIVATE EQUITY – VENTURE CAPITAL MANAGER ANNUAL UPDATES

Ms. Fowler introduced herself, stated that both INVESCO Private Capital (IPC) and Pathway Capital Management (Pathway) manage discretionary venture capital portfolios, and explained that their respective contracts require presentation of an annual review to the Committee.

Pathway Capital Management

Ms. Jakobi, Pathway, introduced herself and Mr. Melican and stated that market conditions have shown gradual improvement and that the portfolio has a positive return for the past year. Ms. Jakobi and Mr. Melican described Pathway's organization, global client base, experience, strategy, and cohesive team. They discussed current market trends and history, exit strategies, valuations, fundraising pace, and general fund size. They presented a review of the WSIB portfolio, including allocations, commitments, returns, diversification by industry and strategy, j-curve, commitment remaining to be invested, and performance by vintage year.

Discussion ensued regarding performance, net IRR, commitment remaining to be called, opportunities for future investment, access to quality partners, and pricing position.

Treasurer Murphy asked about the process and amount of investments in Washington. Discussion ensued regarding investments with companies based in Washington State, criteria to be considered a high-quality firm, whether Pathway invests in first-time funds, standards for funds to be considered for investment, pool of uncommitted capital representing all of Pathway's clients, referral by Washington of firms to Pathway and Pathway's response to the firms, unfunded commitments, and the average age of unfunded capital.

Staff committed to send a list of investments by Pathway in Washington companies to the Committee.

INVESCO Private Capital

Ms. Fowler introduced Katie Cattnach and Mary Kelley, IPC.

Ms. Kelly and Ms. Cattnach described IPC's history, organization, operation, investment opportunities, deal flow, experience, expertise, client list, investment process, diversification, and market sensitivity. They described current and historic market conditions and trends, smaller fund sizes, deal competition, lower expected returns, valuations, exit strategies, globalization, and investment focus.

Ms. Cattnach and Ms. Kelley reviewed IPC's portfolio. They discussed allocations and returns by vintage year and company, average size of distributions, market volatility, recent initial public

offerings (IPOs), performance, number of active companies in the portfolio, diversification by stage and geography, and investments in Washington-based companies.

Treasurer Murphy asked about the process and amount of investments in Washington. Discussion ensued regarding the number of Washington-based investments, investments in first-time funds, referral by the WSIB of companies to IPC and IPC's response to those companies, IPC's screening process and criteria, and quality and potential of Washington-based companies as opposed to those from other states.

IPC will provide a report on the number of Washington-based companies reviewed by IPC to include companies reviewed, fund size, response, decision, and rationale. The report will be updated semi-annually.

Discussion ensued regarding competition between Pathway and IPC, and the recent AMVESCAP settlement.

[The Committee recessed at 11:30 A.M. and reconvened at 11:52 P.M.]

REAL ESTATE – PRINCIPAL ENTERPRISE CAPITAL 1, LLC – FOLLOW-ON INVESTMENT RECOMMENDATION

Mr. Bruebaker introduced himself and explained that the WSIB approved a \$400 million commitment to Principal Enterprise Capital 1 (PEC) in September 1998 and an additional \$400 million commitment in July 2000. He stated that PEC provides small to medium real estate operating companies (REOCs) with an alternative capital strategy not typically available in the market place. Mr. Bruebaker discussed PEC's appeal to real estate entrepreneurs, the advantages of sourcing by local entrepreneurs as owners rather than providers, commitment to long-term investing, approach to business as principals, and focus on value creation rather than fundraising. He explained that the PEC platform should continue to provide the WSIB with long-term, quality investments. He stated that the key terms and conditions are favorable to the WSIB. Mr. Bruebaker explained that this investment opportunity came before the Committee in June. The Committee heard discussions of a possible conflict of interest as a result of a former employee assisting in the editing of a private placement memorandum (PPM) dated March 16, 2004. Staff made the recommendation based in part on advice from the Board's fiduciary counsel that the Committee could reasonably conclude that neither the staff nor the consultant were unduly influenced by the work of the former employee, and that the Committee could reasonably rely on the work as a basis for recommending the investment. The Board's fiduciary counsel did recommend that the Board consider an additional step of obtaining an independent review by a firm that had not been exposed to the 2004 PPM as an added precautionary step. It was the consensus of the Committee to send the matter to the Board. The staff recommended to the Chair of the Board and the Chair of the Private Markets Committee at the June 2004 Board meeting that staff obtain additional assurance by having a new review and recommendation provided by a firm with expertise in real estate matters that had not been exposed to the 2004 PPM. The Townsend Group (Townsend) was hired to act as a fiduciary to the Board to perform due diligence upon the follow-on investment opportunity with PEC. The due diligence included review of the investment strategy, the existing track record of PEC, fees and manager performance incentives, skills, capabilities, and experience of PEC's investment team. Mr. Bruebaker stated that he is making this recommendation not only with this fresh, independent review of the merits and risks associated with the investment opportunity, but also with an opinion from Paul Silver, the WSIB's Assistant Attorney General, that

there is no longer a concern relative to any potential conflict of interest in the decision-making process, and any taint, if there ever was any, has now been completely removed.

Ms. Byrne, Townsend, introduced herself and Ms. Assante. Ms. Byrne stated that Townsend recommends that the WSIB make an additional \$600 million investment in PEC 1. She explained that PEC 1 is an exceptionally good fit for the WSIB. She discussed PEC's strategy, access to transactions, expertise, long-term flexible investment horizon, alignment of interests, performance in the top quartile, structure, and resources. Ms. Byrne explained that this commitment triggers a provision in the agreement that requires this service to the WSIB on an exclusive basis, which adds very significant value. She described the scope of Townsend's review. Ms. Byrne discussed the risk management structure of PEC 1, management expertise, focus on building the portfolio, fees, expenses, incentive structure, and policies and procedures.

Ms. Assante discussed incentive hurdles, the potential effect of institutional perspective on entrepreneurial strength, and portfolio construction.

Discussion ensued regarding incentive hurdles and audit findings.

Mr. Schulte and Mr. Schoon, PEC, introduced themselves. Mr. Schulte provided an overview of PEC. He discussed PEC's acquisition, development, and management of REOCs. He described PEC's capitalization, organizational structure, long-term focus, strong alignment of interest, control function, risk-adjusted returns, investment characteristics, business model, strategy, and diversification. He discussed PEC's six operating companies, their managers, and plans for future investments.

Discussion ensued regarding frequency of meetings between PEC, the managers of the REOCs, and the WSIB staff.

Mr. McElligott stated that it was the consensus of the members present to forward this item to the Board for consideration of a follow-on investment of up to \$600 million, plus fees and expenses, in Principal Enterprise Capital 1, LLC, subject to continued due diligence and final negotiation of terms and conditions.

REAL ESTATE – LONE STAR FUND V (U.S.), L.P. – INVESTMENT RECOMMENDATION

Mr. Draper introduced himself and Ms. Jirasetpatana. Mr. Draper stated that the fund will be oversubscribed and investors' allocations will likely be reduced. He explained that to compensate for the allocation reduction, staff has increased their recommendation from \$400 million to \$450 million.

Ms. Jirasetpatana introduced herself. She explained that this is an existing relationship and that the Board approved commitments to the first four Lone Star Funds. Ms. Jirasetpatana discussed commitments, returns, net IRR, multiples, quick return of capital, and unrealized value in funds not fully liquidated. She explained that Fund I underperformed; however, Funds II, III, and IV are on track. Ms. Jirasetpatana stated that staff recommends a \$450 million investment in Fund V. She described the fund's strategy, geographic focus, dominant global franchise, superior expertise, risk-adjusted returns, experienced management team, investment platforms, local operating platforms, access to deal flow, market flexibility, solid track record, and existing WSIB relationship. She discussed market risks, increased competitive landscape, exit strategies, foreign tax liabilities, currency issues, key man provision, fit in the WSIB real estate portfolio, diversification, and geographic concentration.

Treasurer Murphy asked about the somewhat unique structure of the fees. Discussion ensued regarding terms and conditions, preferred return rates, carry, and catch-up.

Mr. Humphrey, Courtland Partners, introduced himself. He discussed fees, terms, and conditions, Lone Star's track record, strategy, competition, flexibility, diversification, and unique approach.

Discussion ensued regarding time-weighted versus dollar-weighted returns, net IRR, and projected appreciation. Actual returns with both time-weighted and dollar-weighted returns were provided to the Committee.

Mr. Ellis, Lone Star, introduced himself. He discussed Lone Star's organization, global diversification, and principals. He described Fund V's platform, investment strategy, target fund size, target allocations, target investment returns, target investment holding period, structure, terms, and fees.

Discussion ensued regarding the reduction in the preferred return rate, reduction in management fees, carry, catch up, tier-promote structure, track record, history, diversification, capital called, capital returned, fund size, projected IRR versus actuals, returns, volatility, due diligence, exit strategies, competition, foreign markets, differences in European versus Asian markets, and valuation process.

Mr. McElligott stated that it was the consensus of the members present to forward this item to the Board for consideration of an investment of up to \$450 million, plus fees and expenses, in Lone Star V, subject to continued due diligence and final negotiation of terms and conditions.

PRIVATE EQUITY – SECONDARY INVESTMENT OPPORTUNITY

Mr. Bruebaker explained that in accordance with policy, staff has made secondary investments described in the packet. He stated that in the future Mr. Dear will inform the Board of secondary investments in his monthly report.

PRIVATE EQUITY – ANNUAL COMMITMENT PLAN UPDATE

Acting Chair McElligott announced that the Committee would go into executive session under the provisions of RCW 42.30.110(k) to discuss financial and commercial information relating to the investment of retirement funds, since public knowledge regarding the discussion is likely to result in loss to the funds managed by the Board or in private loss to the providers of the information.

The Committee expected the executive session to last 15 minutes. At the end of the executive session, the Committee would reconvene to adjourn.

[The Committee went into executive session at 2:10 P.M., and the regular session reconvened at 2:30 P.M.]

PRIVATE MARKETS CLOSING LOG

The Private Markets Closing Log was presented for informational purposes.

OTHER ITEMS

There being no further business to come before the Committee, the meeting adjourned at 2:30 P.M.